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Economic Times

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Editor's Note:

Lots of goodies for this first issue of the new year. The Colloquium explores a major new question about the current business cycle. Next, Ken Chilton enlightens us about a once-dull now-contentious topic: how to get rid of our garbage. Then some insightful thoughts from London about political leadership and (thanks to long-time friend Lowell Harriss) about justice in Ancient China. These are followed by the second edition of our special quarterly feature: The Industry Outlook Report. After that you will find a synopsis of how the Continental Illinois Bank was rescued six years ago, and a look at the 1990 performance of the world's 10 largest stock markets. And finally, our Stat File and Crystal Ball. All in all, quite a tasty smorgasbord.

I trust it's not too late to wish everyone a pleasant and prosperous 1991.

Ed Fiedler

Maxim of the month:

The Eiffel Tower is the Empire State Building after taxes!

Senator William Roth in the Tax Foundation's "Tax Features."

Does Debt = Disaster?

Q: Debt is going bad everywhere: Leveraged buy-outs, home mortgages, S&Ls, even the biggest commercial banks. The daily headlines about this crisis tell us the world is coming to an end, right?

A: *The headlines say so, yes, but the conclusion may or may not be valid. As always, the headlines exaggerate the bad news. Beyond that, how serious this is depends on your perspective: From the (micro) point of view of a threatened financial institution, the risk of the world coming apart may be high. From the (macro) point of view of the economy as a whole going into something like a Great Depression, the risk is small.*

Q: But what if a major bank or three go under?

A: *Big problems for their stockholders and top executives, but it shouldn't impact heavily on the economy as a whole. It should sort itself out out like the rescue of Continental Illinois. The FDIC takes over, installs new managers, the Fed temporarily supplies extra credit to the banking system, and most everything goes on as before.* *(For a more detailed review, see p. 7.)*

Q: What if the FDIC runs out of funds?

A: *The President and Congress, after the usual sound and fury trying to fix the blame elsewhere, will tell the Treasury to replenish the FDIC's resources.*

Q: Whoops! Not so fast! The Treasury has to borrow those extra billions. Won't that raise interest rates and push the economy still deeper into recession?

A: *It shouldn't. The Federal Reserve (in effect) prints the extra money but, in contrast to the usual process, when the FDIC passes the money through to keep John Q. Citizen's bank balance safe, nothing much changes in the financial system. It's a wash transaction: The dollars borrowed from the capital markets by the Treasury are put directly back into the capital markets by the bank or thrift without financing any new economic activity. The one change is the extra billions of Federal deficit, but during a recession the extra deficit is easy to finance, and inflation is easing not accelerating.*

Q: So, no problem?

A: *Whoa! I'm arguing "no disaster," not "no problems." Many banks, thrifts and others have serious problems, such as declining real-estate values, increased FDIC fees, and the need to strengthen their capital. At the macro, economy-wide level, we have the problem of inadequate saving and investment and from a shorter perspective we have a recession. Further, the new regulatory requirement that banks increase their capital base substantially may seriously complicate the task of dealing with the recession.*

Q: How so?

A: *By inducing many banks to tighten their lending standards, which if widespread could stifle the recovery. In response — assuming this is a full-fledged recession — the Fed will probably ease credit more aggressively than usual — which means that interest rates could fall even more than normal for a recession — and it's also likely the regulators will postpone the timetable for increasing bank capital. But the impact of this regulatory change is an important new issue, which is why we asked the Colloquium to discuss it — on the next page.*

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Colloquium

Background:

A special twist of the current business cycle is the impact of troubles in the financial sector of the economy. The S & L crisis is the best known part of that. The fall in real estate values probably has the most widespread impact. And the enhanced capital requirements imposed upon commercial banks by their regulators may be the most significant for recovery prospects.

Question:

Will the fragility of the financial sector deepen the recession or retard the subsequent recovery or both? If so, what should the policymakers be doing in response?

Robert G. Dederick
Northern Trust Company

Fragility, what fragility? Surely the questions must refer to some other nation, perhaps on the opposite side of the Pacific. But, if perhaps I am mistaken, the proper answer to Query #1 is "it all depends" — on public policy. If regulatory policy is properly supportive and monetary policy is appropriately stimulative, then financial fragility need not be a meaningful constraint. But if these policies are not as stated, then similar actions will have to be taken later in any event (thereby answering Query #2).

Andrew F. Brimmer
Brimmer & Company

The "credit crunch" will make the recession deeper and retard recovery. Without it, real GNP would probably decrease by 1 percent from the third quarter of 1990 through the first quarter of 1991. Instead, we may suffer a three-quarter decline of 1.5 percent. To ease the adverse impact, bank examination standards should be relaxed further. The January 1 increase in bank capital requirements should be delayed, and bank reserve requirements should be cut by 10 percent.

Murray Weidenbaum
Center for the Study of American Business

The vulnerability of financial institutions underscores the weaknesses in the real economy. The Fed should start paying interest on compulsory deposits by banks (known as "reserves") and bank regulators should think hard before promulgating new requirements. Congress is hardly helping by waiting until a downturn to raise taxes and impose expensive new regulatory restrictions on business. Government loves to sympathize with voters hit by recession while taking dumb pro-cyclical actions.

James Tobin
Yale University

The 1980s recovery survived stock market crashes and S&L disasters. Now, with bad loans threatening banks, can the Fed engineer a 1990s recovery? Sure, if Greenspan eases promptly and decisively. The driving force will be exports rather than housing. Low interest rates are still the key; they lower the dollar. Despite recession and Brady's sympathy for beleaguered bankers, Congress must protect taxpayers from again holding the bag for imprudent and under-supervised financial institutions.

Members:

Members of The Conference Board Economics Colloquium are: Stephen H. Axilrod, Vice Chairman, Nikko Securities International; Andrew F. Brimmer, President, Brimmer & Company; Don R. Conlan, President, Capital Strategy Research; Robert G. Dederick, Executive Vice President and Chief Economist, Northern Trust Company; John T. Dunlop, Lamont University Professor Emeritus, Harvard University; Lyle E. Gramley, Senior Staff Vice President & Chief Economist, Mortgage Bankers Association; Isabel V. Sawhill, Senior Fellow, The Urban Institute; Charles L. Schultze, Senior Fellow, The Brookings Institution; James Tobin, Sterling Professor Emeritus, Yale University; Laura D'Andrea Tyson, Professor of Economics, University of California, Berkeley; Charls E. Walker, Chairman, Charls E. Walker Associates; Murray Weidenbaum, Director, Center for the Study of American Business; Albert M. Wojnilower, Senior Advisor, First Boston Corporation.

Garbage!

An interview with
Kenneth Chilton
Center for the Study of
American Business

Economic Times: Am I correct, Mr. Chilton, in describing you as "one of the world's great garbage economists?"

Chilton: *Hmm... I don't know whether to be flattered or insulted. I think I will just plead the Fifth Amendment.*

ET: What should we do about the garbage crisis?

Chilton: *The first thing to do is to quit treating it as a* ***crisis****. It's properly regarded as a* ***problem*** *and a* ***challenge****, and in some ways as an* ***opportunity****. To think of it as a* ***crisis****, however, interfere's with sensible analysis and a rational response.*

ET: What should be done?

Chilton: *There are really only four basic options: Source reduction, recycling, incineration and landfilling. We need a fully integrated approach using those four methods based on the criteria of safety and cost-effectiveness.*

ET: According to some environmentalists, we should only "reduce and recycle." Given the problems of incineration and landfilling, isn't that a good idea?

Chilton: *Reduction and recycling have nearly reached the level of public support given motherhood and apple pie. But no, we should not limit our options to those two, not in a world of limited resources. That's what I had in mind in calling for an* ***integrated*** *approach, meaning a systematic look at all four options, as opposed to the* ***ad hoc*** *approach so often used now. For most solid waste, source reduction and recycling are just too expensive. As long as we have other important things to do with our money, we don't want to spend more than we have to for satisfactory garbage disposal.*

We're running out of safe landfill space? No! That's one of the pernicious myths of the garbage biz.

ET: Are you saying we shouldn't make any special effort to reduce the amount of waste?

Chilton: *We should make a full effort at source reduction everywhere we can at reasonable cost. We should, for example, build the cost of disposal into the initial price of environmentally difficult products such as rechargeable batteries. What we shouldn't do, in most cases, is to impose outright bans on a substance or a product, because such bans, in addition to being expensive, often produce unintended side effects. For example, in the 101st Congress, a solid waste bill surfaced in the Senate that would have prohibited the use of cadmium. The primary target seems to be the cadmium used in rechargeable batteries. But artists are outraged, understandably, because there is no acceptable substitute for cadmium in producing bright red, yellow and orange hues. Use of cadmium by artists would hardly seem to be a significant danger to society.*

ET: What about recycling? Can't we recycle our garbage much more than we do now?

Chilton: *For some things, yes. We do a pretty good job on aluminum now — we're up to somewhere between 25 and 45 percent recycled--and we should be able to take that percentage a bit higher. But aluminum accounts for only 1 percent of municipal solid waste, so even a major improvement isn't going to make a significant dent in the total garbage disposal task. Perhaps the greatest potential for beneficial recycling is residential yard wastes, which make up nearly 20 percent of municipal solid waste.*

So I'm all in favor of recycling where it makes economic sense. But there is too much garbage that simply can't be recycled. Thus I worry about cities that are relying on greatly increased recycling rates to head off a crisis. For example, Seattle decided to increase its recycling rate to 60 percent by 1998 rather than site new landfills or build an incinerator. The city currently recycles at a 37 percent rate, the highest of any major U.S. city. It is possible however, that Seattle's current success could be tomorrow's crisis. Given the long lead times to obtain permits and build new landfills or incinerators, the city is taking a big risk by placing most (if not all) of its eggs in the recycling basket. Will Seattle officials prove to be farsighted prophets or merely wishful thinkers? Only time will tell.

ET: That leaves incineration and landfilling. Aren't both rife with problems?

Chilton: *Neither one is ideal or problem free, of course. But both have important roles to play in an integrated waste management system. Public concern about incinerators focuses on the unhealthful residues of metals and organic chemicals in air emissions and ash. Just last year, however, the Municipal Solid Waste Task Force in its final report to the EPA concluded, "although combustion is not risk-free, a state-of-the-art combustor that is well operated should not present a significant risk to human*

health and the environment." That is less of an iron-clad guarantee than many environmentalists are after, but it should be enough for most people.

ET: From here it sounds like less risk than we take everytime we get into an automobile. What about turning garbage into energy?

Chilton: *A great idea, but the economics of waste-to-energy plants is less than compelling. The plant costs are high. But when we take account of the avoided cost of alternative garbage-disposal methods, sometimes it can pay to produce energy by burning garbage.*

ET: Let's go back to landfills. How can they be part of the solution when we're running out of safe landfill space?

Chilton: *We're not. That's one of the pernicious myths of the garbage biz. It's true that heightened environmental awareness has increased resistance to new landfills — despite the significant decline in environmental risk from these facilities — but we are not running out of geologically suitable sites. A recent environmental survey of less than half of New York State identified sites totaling 200 square miles.*

ET: But how about plastics, since they don't biodegrade, shouldn't we keep them out of landfills?

Chilton: *Another myth. Plastic is not the overwhelming presence it's cracked up to be. All plastics account for only 7 percent of municipal solid wastes, and polystyrene — public enemy number one in the environmentalist's view — only a few tenths of one percent. Furthermore, the fact that plastic doesn't biodegrade is as much a virtue as a sin. It means that plastic doesn't release chemicals into the groundwater.*

ET: Looking ahead, how do we go about dealing with the problem?

Chilton: *Let me suggest two principles to guide future action. First, garbage is primarily a local problem. At the federal level, the EPA should play a key role collecting and disseminating information. And state officials can serve as agents to resolve disputes among localities. Otherwise, local authorities are normally best positioned to make garbage-disposal decisions.*

The clear motivating factor in Seattle's sucessful program is the "pay as you throw" system of trash hauling.

Second, we should maximize the use of market incentives. The greatest "market failure" connected with solid waste disposal is the distortion of market incentives resulting from municipal systems that charge flat fees for garbage collection. Cities that collect trash from households as a community service or that charge a single fee regardless of the amount of trash put out by the household are encouraging wastefulness. Consumers are not being made aware of the true disposal costs resulting from their buying and discarding practices.

Seattle's successful recycling program is fundamentally a story of the power of marketplace incentives to change behavior. Although the volunteer efforts involved in Seattle's success have gained a great deal of attention, the clear motivating factor is the fact that residents are faced with a "pay-as-you-throw" system of trash hauling. Homeowners pay $10.70 a month for a 19-gallon mini-can but $31.75 for three full-size, 32-gallon garbage cans. Curbside recycling of plastic beverage bottles, glass, cans, newspapers and other waste paper is free. Four out of five Seattle households recycle and 90 percent put out one or less cans of garbage a week. Basically, it is the high incremental cost for additional garbage cans that has placed Seattle residents at the top of the recycling chart.

ET: But how do you persuade people to accept a landfill in their locality?

Chilton: *Here, too, economic incentives provide a way out of the NIMBY — Not In My Backyard! — syndrome. Citizens do not want recycling centers, incinerators and landfills in their backyards because they reduce property values and adversely affect other non-pecuniary aspects of home ownership — a quiet neighborhood, less traffic congestion and the like. The simple (but not easy) solution is to compensate property owners for their losses. An indirect form of compensation is to provide a public benefit — a firehouse, a park or civic center, or road improvements. Or restitution can be more direct, such as a lump-sum payment, or payment of property taxes for the homeowners.*

ET: Sounds like **bribery** to me!

Chilton: *It could go by many names, both good and bad: hush money, payola, reward, economic incentive. But whatever you call it, the point is that those enjoying the benefits of the waste disposal facility should offset at least some of the costs that are imposed on the areas surrounding the facility.*

ET: Final question: There have been a fair number of reports on this issue in the newspapers and on TV. Have they helped or hurt?

Chilton: *Both. Getting better information to the public is important, and some of the media attention has changed individual and business behavior for the better. But much of the information has been inaccurate, and that hurts. In short, some garbage exposés have been "talking trash."*

ET: Have we talked enough trash for now?

Chilton: *Yes, perhaps we have.*

ET: Thank you very much, Mr. Chilton.

Kenneth Chilton is Associate Director of the Center for the Study of American Business at Washington University of St. Louis. This interview was based on his study, "Talking Trash: Municipal Solid Waste Mismanagement," published by the Center, September 1990.

Quotable Quote

Leadership? *by Jonathan Wilmot*

Reagan has gone, and Bush seems to have got himself trapped in the beltway. In the Soviet Union, even outsiders no longer see Gorbachev as master of the universe. Deng is rumored to be ill, and dying. Kaifu's days look numbered. In Europe, the Delors game plan is going off the rails, and Mrs. Thatcher is history. In the Gulf, the allies muster more firepower than willpower…Never mind the "borderless world," it's the prospect of a rudderless world we now have to face…

A new world order is struggling to be born, and with it a new spirit of the age. It is natural in such times to hanker after strong and decisive leadership to control and shape all this chaos. Natural also to contrast our present leaders with the early days of Reagan, Thatcher, Volcker, of Gorbachev himself. To observe with sadness, or to gloat, that their reputations are tarnished, their convictions seemingly out of date. To fret that government by opinion poll is driving out integrity and steadiness of purpose. To sense that prosperity has both revived the politics of envy and given electorates a fresh taste for the soft option.

Still, I can't suppress some heretical thoughts about this leadership debate. Stalin, for example, would qualify as a "strong" leader, able to impose order on chaos by utterly ruthless cunning. More to the point, conviction politics may be inappropriate, too risky, for times of massive flux. Quiet persistence, flexible response, a talent for cultivating alliances, and avoiding confrontation until it is clearly worthwhile might serve the case better. Real leadership might entail lying in wait for those rare occasions when swift, decisive action is genuinely possible. (In the British case, this sounds more like Major than Thatcher. In the U.S. case, Bush at his best.)

Jonathan Wilmot is Director-Economics at Credit Suisse First Boston Ltd. (London). This commentary is excerpted from his "Market Focus," 16th November 1990.

The Judicial System, Then and Now

Then — Ancient China:

There was a complaint during the reign of the Emperor Kanghsi, one of the greatest Manchu Emperors, about the corruption and tyranny of the courts. The Emperor received a petition, considered it awhile and issued this decree:

"The Emperor, considering the immense population of the empire, the great division of territorial property and the notoriously litigious character of the Chinese, is of opinion that lawsuits would tend to increase to a frightful extent if people were not afraid of the tribunals and if they felt confident of always finding in them ready and perfect justice.

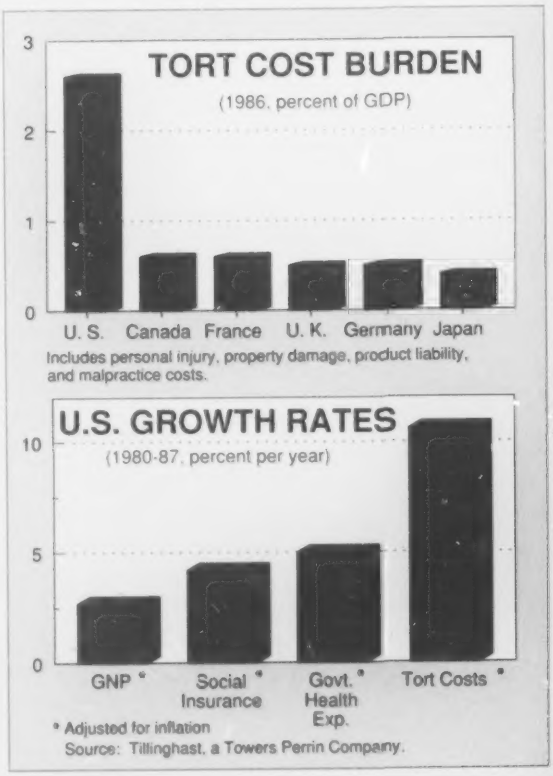
"As man is apt to delude himself concerning his own interests, contests would then be interminable and the half of the empire would not suffice to settle the lawsuits of the other half. I desire, therefore, that those who have recourse to the courts should be treated without any pity and in such a manner that they shall be disgusted with law and tremble to appear before a magistrate.

"In this manner the evil will be cut up by the roots; the good citizens who may have difficulties among themselves will settle them like brothers by referring to the arbitration of some old man or the mayor of the commune. As for those who are troublesome, obstinate and quarrelsome, let them be ruined in the law courts; that is the justice that is due to them."

Judicial reform, under those conditions, was naturally difficult.

Excerpted from "The Geography of China," by Frank Johnson Goodnow, President (then) of Johns Hopkins University, *The National Geographic Magazine*, June 1927.

Now — Present Day U.S.A.



Industry Outlook Report

January 1991

Overview

Edgar R. Fiedler, The Conference Board

The theme among our panelists this month is a business cycle without tears. The recession that was only a strong possibility 3 months ago is now universally accepted. Among those who focus on the general business cycle, the feeling is that the low point will come early in the year but the recovery in sales is likely to be modest rather than robust.

The tenor of the others in the group is consistent with this moderate view of the downswing. It's not looked upon, necessarily, as a routine recession, but there is no hint of panic or anything close. No analyst leaves the impression that his or her industry is headed for insurmountable trouble. Few see any bright light at the end of the tunnel, although several panelists cite international orders as a specific source of strong demand.

Projections of next year's profits, as usual, call for extra uncertainty and caution. Most of those who mention the profits outlook are pessimistic, including agriculture, forest products and, most seriously, steel. Packaged foods is a distinct exception, with profits projected to rise in 1991, albeit at a slower rate.

In several industries, our panelists took comfort from a longer perspective. In telecommunications, for example, telephone lines and long-distance calling have increased every year for the past half century. And our specialist on packaged foods is looking for average annual profits growth of 10-13 percent for the decade of the '90s. Even financial services are expected to return to normal profitability, although not until after the industry completes a massive and painful restructuring over a period of 5-10 years.

In general, the mood of our panelists avoids the extremes. Mostly they are just subdued and sedate. The surprise, in view of the stage of the cycle, is that nothing approaching anxiety or fear appeared.

Steel

Elizabeth A. Bossong Consultant

The outcome in the Persian Gulf is unknowable, but I have assumed that oil will average no higher than $25 a barrel, the collapse in consumer confidence will be at least partially reversed, and there will be no additional credit crisis and some monetary easing. Despite those perhaps-optimistic assumptions, there will be little to cheer about in the economy's performance.

Total domestic steel consumption declined by about a million tons last year as higher capital spending, strong export demand for machinery, gains in energy markets, and public-construction increases only partially offset the sharp declines in automotive production and housing. Steel shipments, however, slightly exceeded the 1989 total of 84 million tons, aided by both customer strike-hedge inventory building late in the year and some price hedging.

The dramatic improvement in the steel trade deficit has been vital to the recovery in steel over the past few years. Between 1984 and 1989, when domestic usage was essentially unchanged, the gains in foreign trade — from a 25 million ton deficit to one of 13 million tons — brought about a 10 million ton increase in industry shipments. Further trade improvement is unlikely in 1991 but, given a fairly strong world economy, the weaker dollar and reduced domestic usage should preclude deterioration.

In 1991, machinery output will slow in reaction to the decline in corporate cash flow, partly offset by still strong export demand. A sharp drop is probable for private nonresidential construction moderated by a relatively stable public construction picture. While the trend should be upward during the year, on an annual basis little recovery is expected in housing and automotive uses. Total steel usage will decline by about 2 percent. Lower consumption and customer inventory cutting, no longer offset by an improving steel trade balance, will drop shipments to 77-80 million tons. Higher costs, lower operating rates, and little if any price relief suggest a further decline in industry earnings. Given the efficiency of the industry and the decline in the dollar, a return to the ruinous price cutting and huge losses of the 1982-1986 period seems unlikely.

	1989 actual	1990 estimated	1991 projected
Industry Shipments *(Tons, Mil.)*	84.1	+1%	-8%
Net Income *($ Bil.)*	1.5	-57%	-60%

Petroleum

James W. Hanson
Consultant

World oil markets have once again been buffeted by developments in the Middle East. Much as in 1973 and 1978-79, oil prices soared, consumer and business confidence plummeted, and economists began marking down their forecasts. Thus far, however, the third oil shock appears less menacing, both to oil markets and to economic prospects, at least in the industrial world.

Oil markets and prices would have already returned to pre-crisis sluggishness if the political trigger were simply the embargo on exports from Iraq and Kuwait. In response to sharply-higher output, together with lower demand prompted by higher prices and slower economic activity, commercial oil stocks are actually at or above year-ago levels.

Comfortable demand-supply balances notwithstanding, oil prices will continue to include a war-risk premium so long as Saddam Hussein refuses to abide by UN Resolutions. The outbreak of war could well validate analysts' projections of $60 oil, at least in the initial stages. On the other hand, the oil-consuming world is far less vulnerable to disruption nowadays. The estimated billion barrels OECD countries hold in strategic storage is equivalent to four months of Saudi production at today's stepped-up rate.

Even if prices remain in the $25-30 range, fully half again year-ago levels, the adverse impact on inflation and economic growth need not be catastrophic. First, oil would still be a relative bargain, with real prices little higher than before the second shock in 1978 — especially in strong currency economies such as Germany and Japan. Second, the industrial countries on average use 40 percent less oil to generate a unit of GNP than in the early 1970s.

In sum, higher oil prices have dampened economic prospects, particularly where, as in the US, recession was already coming. But an early peaceful resolution of the Gulf crisis would find oil prices plunging to $20, perhaps lower, and confidence rising once again. Unlike the earlier oil shocks, OPEC members have been promoters of price moderation and market stability. Moreover, consuming country governments have resisted "knee-jerk" policy responses, particularly oil price and profit controls. Higher oil prices have boosted earnings for both government and private producers, but most of the latters' gains have been offset by thinner margins in refining, marketing, and chemical segments.

Forest Products

Lynn Michaelis
Weyerhaeuser

The situation in the forest products industry is a good benchmark for the extremes emerging in the U.S. economy.

Growth in demand for paper products slowed during 1990 in line with the overall economy. Strong growth in export sales has offset slower domestic sales. North American producers are in their strongest competitive position since 1979 relative to Scandinavian producers. The biggest challenge for these businesses in 1991 will be the capacity growth fueled by strong profits and high investment levels from 1987 through 1990. Profits and investment will decline further for this segment in 1991 as demand growth slows during the recession.

The situation in the paper industry is sedate, however, when compared to the dramatic decline in the forest products industry in 1990. First, housing construction dropped due to tougher lending standards. Second, consumer spending for furniture declined in the second half of the year. As a result, product demand dropped sharply (see table). Product prices plummeted in July and dropped further in October. Lumber product prices are 25 percent below year-ago levels. Plywood prices are down 40 percent. Industry margins are now back to or below the depressed levels of 1982.

The drop in margins is particularly severe for western lumber producers, who once again bid timber values too high. Environmental pressures from the spotted-owl decision triggered speculative fever in 1989. Timber costs soared from below $200 per thousand board feet in 1988, to over $400 by early 1990. At today's prices, a producer would lose money on timber purchased at 1989 prices. Thus, lumber production in the West has dropped 26 percent, compared to only 5 percent in the South.

We expect demand to bottom in the first half of 1991, 12 percent below 1988 peak levels. With housing starts averaging 1.0 -1.1 million units in 1991, prospects for this industry do not look bright.

	1989 actual	1990 estimated	1991 projected
Lumber Demand *(BBF)*	47.8	46.4	42.5
Doug. fir *2x4 price*	$264	$243	$230
So. Plywood *1/2" price*	$211	$180	$165

Financial Services

Karen N. Horn
BANK ONE,
CLEVELAND

Financial services institutions face substantial challenges in the 1990s. All banks must learn how to make money in an increasingly competitive marketplace. Some banks have dealt with the changing marketplace well. Although total industry profit performance is disappointingly low, and many banks are earning insufficient returns, a few banks are extremely profitable. Over the last 40 years, banks, thrifts, and insurance companies have lost market share to largely unregulated providers of financial services such as money market funds. And currently, many banks (and insurance companies) are facing real estate loan problems. This problem arose in part because banks' traditional customers, large corporations, increasingly issued commercial paper rather than borrowing from banks. Thus, real estate developers became particularly welcome customers as substitutes for the traditional borrowers. Because of excessive residential and commercial construction in the 1980s, the supply of developed real estate is presently outstripping demand; for this and other reasons, bank profitability has dropped to its lowest level in several years.

Outlook

Many analysts are unconvinced that financial services companies will significantly improve their profitability any time soon. There is much over-capacity in the industry. Regulatory changes (already made or in the works) will restrict financial institutions' cheap access to the federal safety net: deposit insurance, the Fed discount window, and the payments systems.

We will see a massive restructuring within the next five to ten years resulting in a consolidation of the industry. Along with the restructuring will come tighter management. Surviving banks will be far more focused on their markets and the bottom line. Once this process is complete, I would expect the financial services industry to once again generate profits at historical levels.

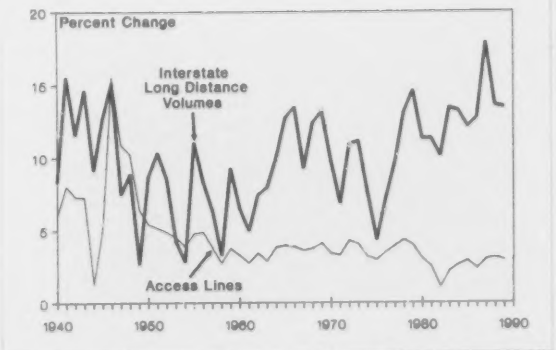
Telecommunications

Kenneth H. Militzer
AT&T

The U.S. telecommunications industry was transformed in the 1980s by a series of dramatic events — the breakup of the Bell system, the loss of AT&T's monopoly in long distance, partial deregulation, the onset of foreign competition, and dramatic technological advances. However, one factor driving the industry did not change — the need to communicate. Indeed, the new products and services spawned in the post-divestiture era have made communications more important to our lives than ever before.

The ever-growing need to communicate — to move and manage information -- has caused both the number of telephone lines and long distance volumes to grow in each and every one of the past 50 years (see accompanying chart). However, with a recession seemingly underway, it is especially pertinent to recognize another historical fact — that growth in both telephone lines and long distance messages has slowed during each of the previous postwar recessions. That situation — slower but continued growth — is likely to continue in 1991. In the services side of the industry, which accounts for the bulk of its revenues, that means growth this year is unlikely to match last year's estimated gains of 10-to-11 percent in long distance volumes, 6-to-7 percent in toll revenues, and 3-to-4 percent in local exchange carriers' revenues.

On the equipment side, shipments in 1990 were supported by a 30 percent surge in exports — a surge that reduced the U.S. trade deficit in telecommunications equipment from $1.9 billion in 1989 to about $600 million in 1990. Continued growth in exports should partly offset the recession's impact on this part of the industry in 1991. Even so, the growth in shipments of telecommunications equipment in 1991 is likely to fall considerably short of last year's 11 percent rise.



Agriculture

John Schnittker
Schnittker Associates

For the fourth consecutive year, U.S. farmers earned record incomes in 1990. At $51 billion, overall net income is one third above 1986, the last year of the recent farm recession. Cattle and hog prices rose as red meat supplies declined 3 percent, and expansion of poultry production just offset the reduced red-meat supplies. Farm prosperity in 1990 was especially important to the inter-mountain and western states, still laboring under a serious drought.

Grain prices declined in the second half of 1990 on the heels of record world harvests, and they may decline well into 1991. Grain farmers, however, are protected by government payments, which increase when prices fall. Grain exports will also fall this season because of huge supplies abroad, the confrontation with Iraq, and financial distress in the USSR.

U.S. farmers are apprehensive about 1991. The farm bill and federal budget policy reduced planned government spending on farm programs for 1991-95 by one fourth. A recession may reduce the demand for red meats, the bedrock of farm prosperity in 1990. Farmers fear a trade war in 1991 and 1992. The U.S. would fight the European Community's farm subsidies by dumping our grains and oilseeds on world markets at low prices.

Finally, farm costs will be $4 billion higher than in 1990 if oil prices are in the area of $35 per barrel. Take away $2 billion in government subsidies, and a similar amount from lower livestock prices, and farmers could face a 10-15 percent income drop. This will slow the purchase of machinery and other capital items, and add slightly to the general economic recession.

	1990 estimated	1991 projected
Farm income	+4%	-10 to -15%
Retail food prices	+6%	+4%

Retail food prices, up over 5 percent in 1990, should rise by only 4 percent in 1991, almost entirely as a result of general inflation. Farm prices, on average, may be slightly below 1990 levels.

Packaged Foods

G. Leonard Teitelbaum
Merrill Lynch

The old adage that "no matter what happens, people have to eat" forms the underlying premise that food-industry profits should continue to increase in 1991 — albeit at a somewhat slower pace than in the recent past. After a general rate of 12-14 percent earnings growth in the 1980s, a 10-13 percent growth rate in the 1990s seems to be a reasonable expectation, given the structural changes that have occurred in the recent past. Food giants have gotten back to basics; they have divested much, if not all, of their non-food businesses and increased the competitive temperature. Commodities prices, which peaked after the drought of 1988, have declined, which has allowed an increase in advertising and promotional budgets.

A recession may well alter the mix of product sold by food companies: Products perceived to be luxury items may give way to more basic items. The more basic items, moreover, generally carry better operating margins than do many less-mature products. We continue to project growth in the convenience-oriented microwave-product category and, depending on the length and depth of a recession, expect growth in the refrigerated foods category to be particularly newsworthy.

An issue that has begun to surface and that could affect the packaged food industry after 1991 deserves some mention. The issue is company size. In the food industry, size has typically meant leverage, which in turn has meant shelf space, and that has meant dollars. Although that premise has not necessarily changed, what has changed is the perception of what constitutes a large company. At present, two packaged-food companies are projected to have revenues of more than $20 billion for 1991. Analysts used to regard as large a company with $6-8 billion in revenues, but that amount may only constitute a medium-size company in the 1990s.

International opportunities for several food companies may also receive more attention in 1991. Depending on country and product line, companies' international divisions could add 1-2 percentage points to the internal growth rate of the industry.

The Continental Illinois Rescue: Many Parallels to 1990

by Raphael Soifer and Nancy A. Bush

If another "run" were to begin tomorrow at a money center bank, the Continental example from 1984 sheds considerable light on the sequence of steps likely to be followed.

The first steps taken in the case of Continental Bank were the reassuring statements made by the bank itself and by the Comptroller of the Currency. When those proved insufficient, the authorities made certain that short-term liquidity was provided to the bank. This was done at first through lending at the Fed discount window, then by organizing a line of credit among major U.S. banks, a technique repeated numerous times since to help various regional banks.

The Fed's reclasification of Continental Bank to the "extended credit" category meant that the funds it could make available to the bank were essentially unlimited

When that proved inadequate by itself, the FDIC made a direct investment of subordinated capital, a step that had earlier been sufficient to save First Pennsylvania. In Continental's case, the investment was accompanied by a blanket liquidity guarantee which ultimately saved the bank; although the run on the bank continued for several months, action by the Fed and FDIC under their liquidity guarantee enabled withdrawn funds to be replaced and services to bank customers to continue without interruption. The Fed's reclassification of Continental Bank to the "extended credit" category meant that the funds it could make available to the bank were essentially unlimited.

Once it developed that Continental's capital would be used up by mounting credit losses, with the liquidity guarantee in place the authorities then sought to arrange the merger of Continental into a healthy institution. That step worked well in the rescue of Seattle First, which was acquired by BankAmerica in 1982. Only after Continental's merger possibilities had been exhausted did the regulators' attention turn to the rescue package that was finally adopted.

Lessons for Today's Investors

- One lesson has already been learned by the nation's money center banks, which today are far more liquid and able to withstand shocks than was Continental in 1984. In addition to the factors on the asset side of the balance sheet, such as the ratio of bank loans to investments, banks have done a lot of work on their liability mix, greatly reducing reliance on volatile purchased funds. In addition, secondary market trading in bank loans is far more prevalent today than in previous cycles, making banks' loan portfolios themselves more liquid than they used to be.
- At no point in Continental's decline and eventual fall were the interests of the bank's depositors and general creditors ever allowed to be at risk. On the other hand, the shareholders of the holding company were essentially wiped out and only a unique set of circumstances protected its bondholders.
- The size of the FDIC's bank insurance fund did not pose a meaningful limitation to its role in Continental Bank's rescue, nor do we believe it would have even if the bank had been considerably larger. The reason for this was and is the FDIC's continuing ability to borrow from the Federal Reserve system, which as we have seen is capable of acting essentially without financial limitation to protect the banking system. Nor was there ever any question of the authorities being able to act quickly enough to save the bank.

One lesson has already been learned by the nation's money center banks, which today are far more liquid and able to withstand shocks than was Continental in 1984.

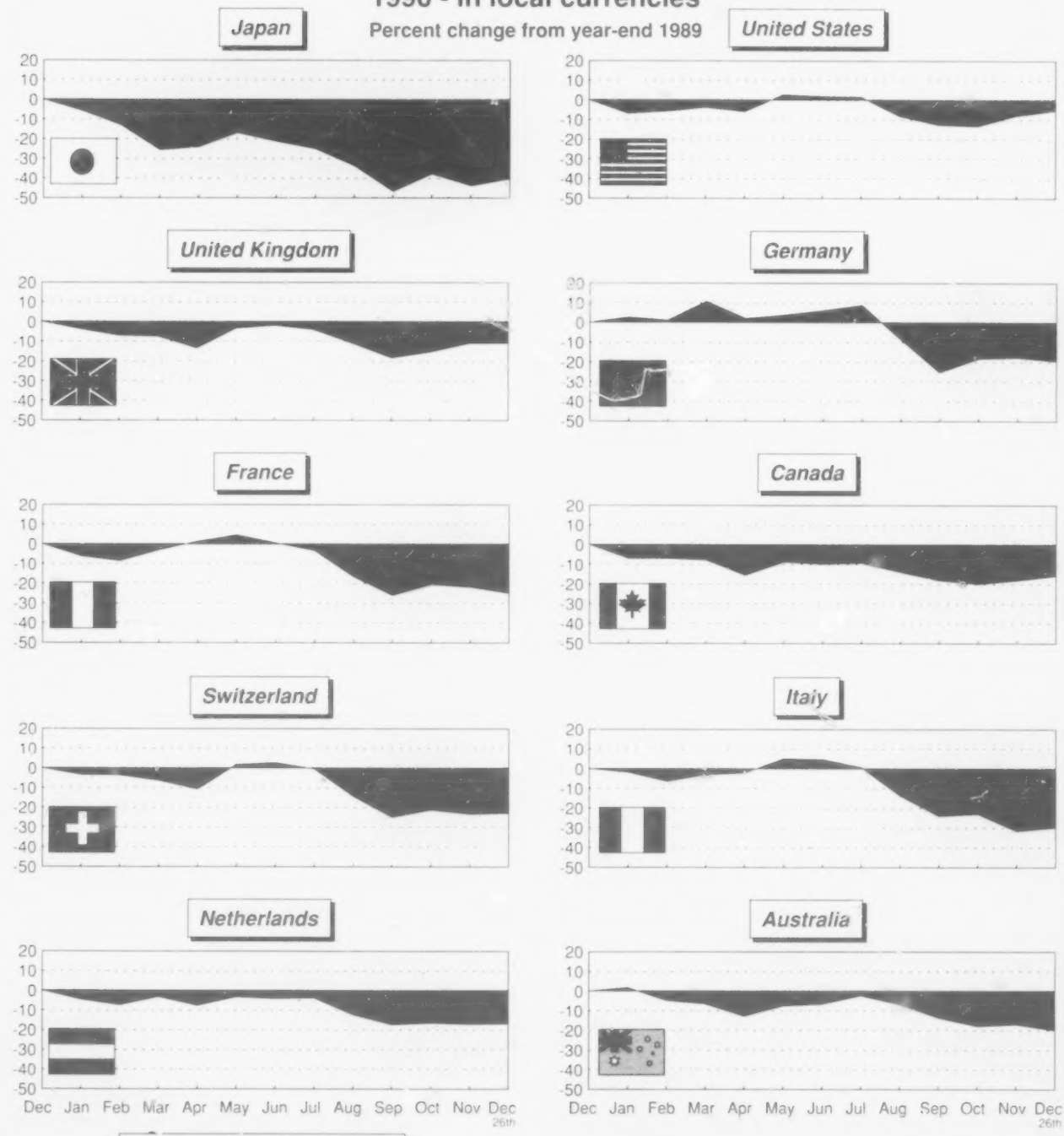
- To be sure, the rescue was not without cost. Part of the cost was the impact of the additional reserves created by the Fed in the course of the rescue--their impact on inflation and interest rates. However, as measured by the market for long-term Treasury bonds, the negative effect was short-lived. History, then, does not support the arguments of those who worry that a banking crisis would result in massive inflationary pressures and a bear market in bonds.

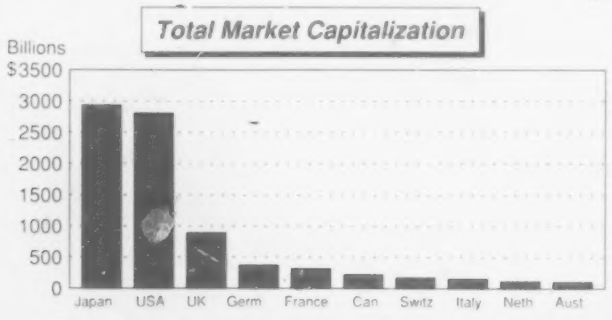
Excerpted from Brown Brothers Harriman & Co., *Banking Outlook*, November 26, 1990.

Stock Prices Around the World

1990 - in local currencies

Percent change from year-end 1989





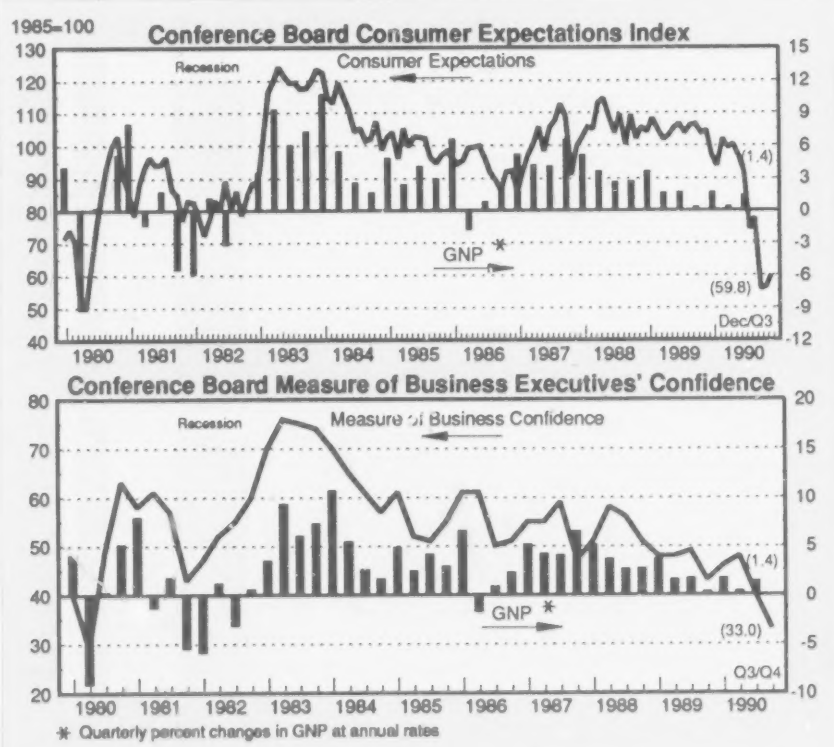
Data source: Morgan Stanley *Capital International Perspective*

Bad Year For Equities. In 1990 prices fell in all of the world's ten largest stock markets. Japan had the worst plunge, down 40 percent, while the U.S. showed the smallest decline, 5 percent. Within the year, the pattern was quite similar in all countries, especially the sharp drop with the Gulf crisis. Recently, eight of the ten markets have shown some recovery, but in most cases not enough to encourage business-cycle forecasters.

Conference Board Stat File

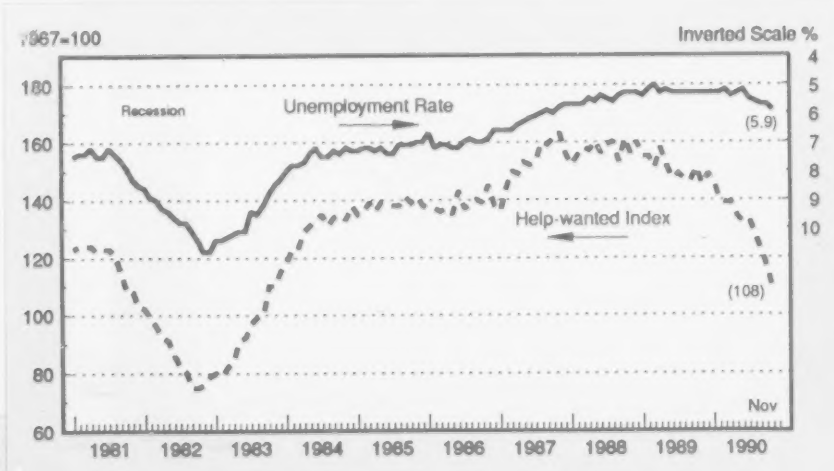
If any doubt still exists about the extent of weakness in the economy, this month's Stat File should quickly dispell it. Every statistical series included here has either reached a level consistent with recession or is headed decisively in that direction. All a casual observor has to do is glance quickly at the two confidence measures, the help-wanted index, and the three diffusion indexes. The latter, which show how widespread the cyclical weakness has become, are the most compelling. The jury is still out on the length and severity of this business cycle — we are two months away from having the data necessary to reach an initial judgement on that question — but the recession-or-no question is no longer worth debate. *(Note: Data for Conference Board series in this section are available upon request from Ken Goldstein at 212-339 0331.)*

Confidence



Very low readings.

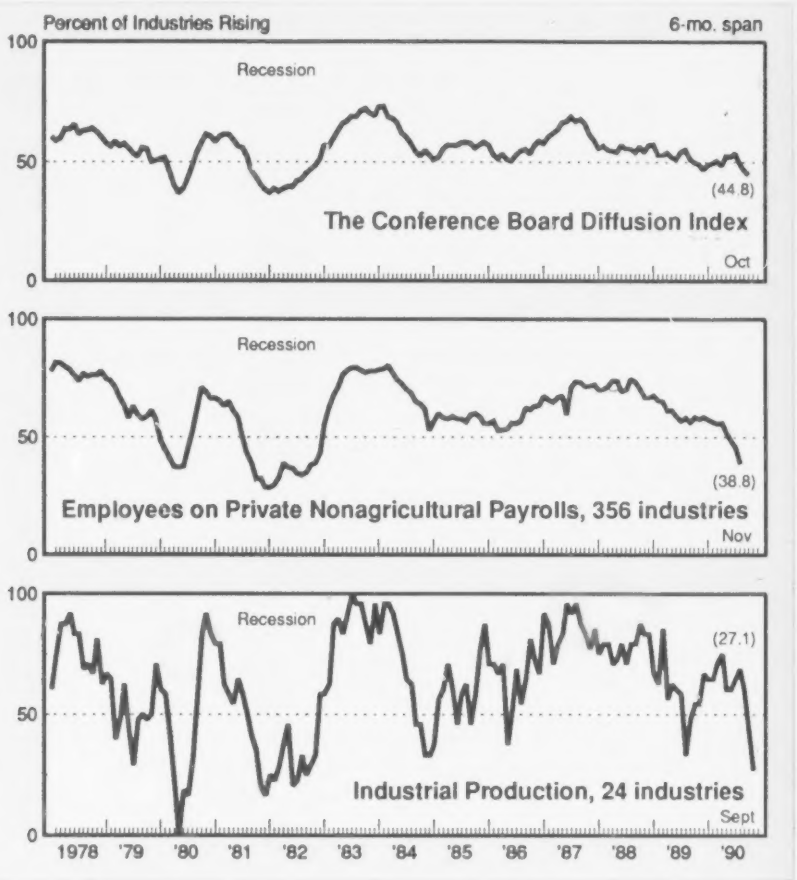
Help-wanted Advertising and Unemployment



Labor markets continue to sag.

Conference Board Stat File

Indexes of Economic Momentum

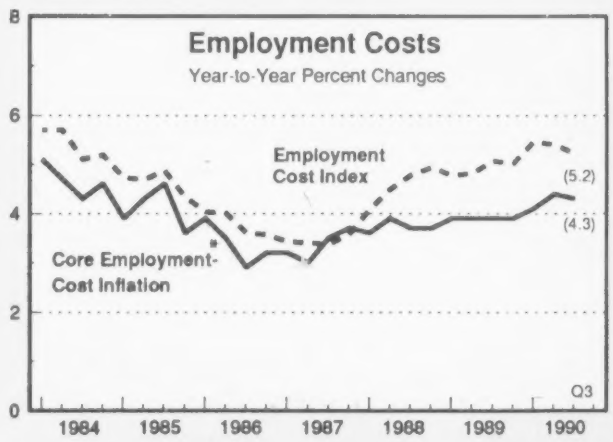


Downturn spreading rapidly.

Core inflation is not following the surge in energy prices.

Inflation Fundamentals

* Core inflation = CPI excluding food at home and energy.



* Core employment-cost inflation = wages and salaries of private sector workers excluding sales personnel (i.e.,excluding the benefits that are part of the ECI)

Inside the Crystal Ball

		UCLA	MERRILL L.	DU PONT	GEORGIA ST.	CONF. BOARD	L.H. MEYER	DRI	WEFA		
Date of Forecast		Dec.	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.		
Gross National Product											
		(Quarter-to-quarter percent change, constant dollars, seasonally adjusted at annual rates)									
		%	%	%	%	%	%	%	%		
Actual	1990 2Q	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	2Q 1990	Actual
	3Q	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	3Q	
Forecast	4Q	-1.4	-3.0	-0.8	-2.1	-1.2	-2.4	-2.1	-1.6	4Q	Forecast
	1991 1Q	-1.6	-1.6	-2.1	-0.3	0.9	-2.6	-2.0	-0.6	1Q 1991	
	2Q	-1.6	0.4	-1.8	1.9	2.2	-1.2	-.3	1.3	2Q	
	3Q	1.9	2.2	1.5	2.0	1.4	2.1	2.4	3.3	3Q	
	4Q	3.6	2.7	2.5	1.6	2.0	2.9	3.3	3.2	4Q	
	1992 1Q	5.9	2.6	3.5	-0.2	2.3	3.4	4.9	2.4	1Q 1992	
	2Q	5.1		4.5	3.1	1.8	3.6	4.2	2.4	2Q	
	3Q	3.8		4.5	1.1	2.2	3.3	3.0	2.7	3Q	
	4Q	3.3		4.5	1.6	2.4	2.9	2.9	2.5	4Q	
Inflation (GNP Deflator)											
		(Percent change from same quarter one year earlier)									
	1990 4Q	4.8	4.4	4.7	4.8	4.8	4.6	4.1	4.5	1990 4Q	
	1991 4Q	4.0	4.3	4.6	4.4	4.6	3.3	3.3	3.9	1991 4Q	
	1992 4Q	2.8		4.0	4.7	4.6	2.3	2.9	3.6	1992 4Q	
Unemployment Rate											
		(Percent, quarterly)									
Actual	1990 2Q	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	2Q 1990	Actual
	3Q	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	3Q	
Forecast	4Q	6.1	5.9	5.9	5.8	5.9	5.9	5.9	5.8	4Q	Forecast
	1991 1Q	6.7	6.3	6.4	6.0	6.0	6.4	6.4	6.4	1Q 1991	
	2Q	7.5	6.8	6.8	6.2	6.2	6.8	6.9	6.5	2Q	
	3Q	7.6	7.0	6.9	6.2	6.4	7.1	7.0	6.6	3Q	
	4Q	7.4	6.8	6.8	6.2	6.5	7.1	7.0	6.5	4Q	
	1992 1Q	6.9	6.6	6.7	6.3	6.5	7.0	6.8	6.5	1Q 1992	
	2Q	6.5		6.5	6.1	6.4	6.9	6.5	6.5	2Q	
	3Q	6.2		6.3	6.2	6.4	6.6	6.3	6.4	3Q	
	4Q	6.0		6.1	6.0	6.4	6.4	6.2	6.4	4Q	

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